INTERSTATE STORES, INC. ANNUAL REPORT

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STORE LOCATIONS

1972

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*Mini Marts **Closed, May, 1973

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DIRECTORS

Sam J. Abend
Sol W. Cantor
Walter A. Craig
Seymour B. Ginsburg*
Samuel Hausman
Charles P. Lazarus
M. Lester Mendell
Albert Parker
Paul D. Preger*
Edward C. Schenkel
Harold J. Szold
Robert C. Van Tuyl

OFFICERS

Sol W. Cantor
Chairman

Charles P. Lazarus
Senior Vice President

Walter A. Craig
Senior Vice President

Sam J. Abend
Vice President

Leo Amolsky
Vice President

Richard Chalifoux
Vice President

Daniel L. Reit
Vice President

Edward C. Schenkel
Vice President

Albert Parker
Secretary

Solomon Fisher
Assistant Secretary

TRANSFER AGENT

Bankers Trust Company
New York, New York

REGISTRAR

Manufacturers Hanover Trust Co.
New York, New York

GENERAL COUNSEL

Parker, Chapin and Flattau
New York, New York

AUDITORS

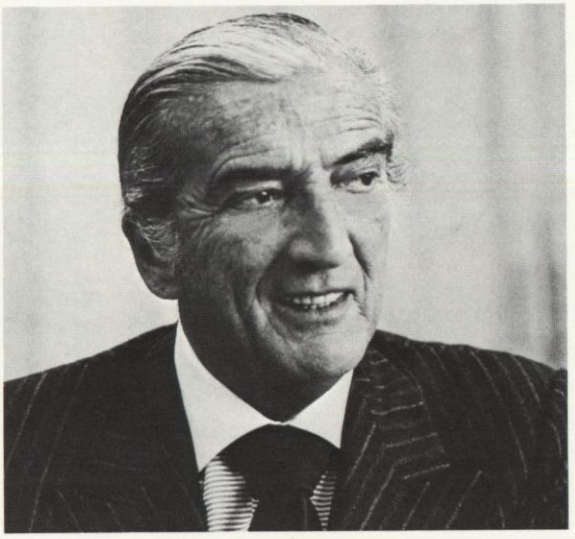
S. D. Leidesdorf & Co.
New York, New York

EXECUTIVE OFFICES

111 Eighth Avenue
New York, New York 10011

Shares listed New York
Stock Exchange—ISD

*Not candidates for re-election.



TO OUR SHAREHOLDERS

The past year was the most decisive and significant, in terms of far-reaching effect, of any since Interstate Stores was founded in 1928. Late in the year the decision was made to restructure the Company so that its profitable operations would have a greater impact on the Company's total performance.

For reasons that have been outlined in previous reports, Interstate's profitability began to decline in 1969. Primary among them were the economic recession that started in 1969, overexpansion of discount retailing in certain key areas which led to intense competition and tightening of profit margins, and high labor costs particularly on the west coast.

In the years since 1969, various programs were put into effect to correct the situation and restore profitability. Last year, after an exhaustive study of each of our stores, it was concluded that these programs would not stem the mounting losses, and that major restructuring was required.

The decision was made to discontinue certain unprofitable discount store operations. Nineteen of the 37 full-line White Front discount stores located on the west coast were closed effective January 28, 1973, and plans were made to terminate 19 Topps stores in the east and midwest this spring and summer. We de-

FINANCIAL HIGHLIGHTS

	1972	1971
Continuing Operations:		
Sales of owned departments	$452,617,000	$451,006,000
Leased department sales	68,765,000	73,370,000
Total	$521,382,000	$524,376,000
Earnings (losses) before taxes	$ (1,683,000)	$ 7,808,000
Provision (credit) for income taxes	(825,000)	3,617,000
Earnings (losses) from continuing operations	(858,000)	4,191,000
(Losses) from non-continuing operations	(6,208,000)	(3,623,000)
Earnings (losses) before extraordinary items	(7,066,000)	568,000
Extraordinary items, net of $629,000 credit in 1972	(33,249,000)	895,000
Net earnings (losses)	$(40,315,000)	$ 1,463,000
Working capital	$ 55,196,000	$ 52,419,000
Current ratio	1.6 to 1	1.5 to 1
Mortgages	23,960,000	26,828,000
Other long-term debt	66,326,000	39,597,000
Stockholders equity	58,527,000	98,718,000

cided to take this step only after it appeared that further efforts to turn these units around would require an excessive investment of funds, energies, and time that could be put to more effective use in other areas of the business.

While other important steps were taken during the year to strengthen store operations, this action in itself should bring about a significant improvement in operating results.

To understand the significance of the effect of the store closings on operating results, we are reporting our figures for the past year by the following classifications: results from continuing operations; results from discontinued operations; and non-recurring charges incurred in store closings.

The stores that are being continued had a loss for the past fiscal year of $858,000. In the prior year the same group of stores earned $4,191,000.

The loss from stores that were discontinued or are to be discontinued amounted to $6,208,000, which compares with a loss of $3,623,000 a year ago for these stores.

Combining the losses of continuing and discontinuing stores, the Company had a net loss from operations of $7,066,000, which compares with a profit a year ago of $568,000.

The costs and losses involved in terminating unprofitable stores amounted to $33,878,000, and these were charged against the fiscal year ended January 28, 1973. They covered principally writedowns of inventories, fixtures and leasehold improvements, real estate costs and other contingencies with respect to the closed stores and those to be terminated in 1973.

Including the non-recurring losses and operating losses, the Company had a net loss for the year of $40,315,000. In the previous year, the Company earned $1,463,000, including an extraordinary credit of $895,000.

In viewing results for the year, it is important to recognize that practically all of the losses were of an extraordinary nature. The losses from non-continuing stores and the net write-offs and reserves amounted to $39,457,000 of the total losses of $40,315,000.

It is also significant that the net operating loss of $7,066,000 for the full year was down from the loss reported for the nine-month period, reflecting earnings that were generated in the last quarter of the year.

Sales of the continuing operations were $521,382,000 last year and $524,376,000 the prior year. Including the non-continuing operations, sales amounted to $683,845,000 and $708,433,000 for the respective years.

In addition to closing unprofitable stores, a number of other important steps were taken to restructure store operations and to restore profitability.

One, we moved ahead with our program for expanding the toy operations. Eight new units were opened in 1972 increasing our chain to 45. Toy sales are now running at an annual rate of about $130 million and are very profitable.

Two, we initiated a new program of opening small discount units specializing in appliances, called White Front mini-marts. There are six such stores operating in southern California.

Three, we prepared for the opening of another suburban department store to be added in 1973; this will bring our group of conventional department stores to 29.

As part of this realignment program, the Company took steps to rearrange and strengthen its financing. In June of this year a new Credit Agreement was concluded with its domestic



Interior of a new White Front mini-mart in Los Angeles. Six were opened during the year.



Eight new Toys-R-Us supermarts were opened in 1972, increasing toy chain to 45 units.

and Eurodollar banks and its insurance company lenders restructuring its loans totaling $69,750,000. Under the terms of the new arrangement, no repayment of the indebtedness will be made until December 31, 1974, at which time $13,950,000 will come due. A similar amount will be due at December 31, 1975 and the balance at December 31, 1976.

In conjunction with the new Credit Agreement, a group of private investors, including myself, have advanced $5,000,000 to the Company, for which the Company issued Senior Subordinated Notes, payable January 1, 1977. The Notes are subordinated to all indebtedness for money borrowed from the banks and other institutional lenders. The subordinated lenders received five-year warrants to purchase an aggregate of 1,000,000 shares of Interstate's common stock at $3 per share.

As part of these agreements, Interstate, which is a holding company, has pledged the stock of its subsidiaries to all the lenders. The Company has agreed among other matters to maintain a certain net worth and a ratio of current assets to total liabilities exclusive of mortgages and subordinated debt, neither of which requirements becomes applicable until July 31, 1974.

The termination of stores and the debt restructuring resulted in a number of changes in the Company's balance sheet. Working capital rose to $55.2 million from $52.4 million a year ago, reflecting a reduction in inventories and accounts payable and the reclassification of the current portion of bank and institutional loans as long-term debt. The size of the Company was substantially reduced as a result of the store closings and the attendant losses. Nevertheless, it had a net worth at year-end of $58.5 million, equal to $10.70 per share.

An important development during the year was the consolidation of the Company's two profitable toy store operations into one, Toys-R-Us, under the direction of Charles Lazarus, founder of Toys-R-Us and President of this division. The consolidation will provide us with a single marketing identity and will produce greater operating efficiencies. Interstate entered the toy field in 1966, with the acquisition of four Toys-R-Us stores in Washington, D.C.

Walter Craig was placed in charge of all Interstate's discount operations early in the year and in October he was made President of Interstate's Discount Stores Division. His is the responsibility of restructuring the Company's White Front and Topps divisions.

On May 1, 1973, Herbert B. Siegel joined the Company as Treasurer.

We believe that the steps taken last year to reorient the Company's operations have placed us on the right track. We will have a better balance between the discount operations on one hand and the toy and conventional stores on the other. Our first objective is to get in the black. The second is to restore the pattern of growth that prevailed over most of the period since Interstate entered discounting.

Progress towards these objectives will come gradually, reflecting first the cyclical character of the Company's operations, with the bulk of its earnings occurring in the last quarter of the year, and second the time that will be required to complete the task of restructuring the Company and restoring normal business relations. Signs of progress should become evident in the latter part of the year as the new character of the Company emerges more clearly, with its profitable toy and conventional store operations making a greater contribution to total results.

We are grateful for the understanding and support of our people in this most trying and difficult period. We believe the actions taken are right and necessary and should lead to the restoration of Interstate Stores as a strong and important factor in retailing.

Sincerely,

Sol W. Cantor, *Chairman*

CONSOLIDATED STATEMENTS OF OPERATIONS AND RETAINED EARNINGS

Interstate Stores, Inc. and Subsidiary Companies

	1972 (Year Ended Jan. 28, 1973)	1971* (Year Ended Jan. 30, 1972)
Continuing Operations:		
Sales and Other Income:		
Net Sales:		
Owned departments	$452,617,000	$451,006,000
Leased departments	68,765,000	73,370,000
	521,382,000	524,376,000
Other Income—Net	1,812,000	614,000
	523,194,000	524,990,000
Costs and Expenses:		
Cost of Sales (including certain buying, occupancy and distribution expenses)	401,742,000	402,448,000
Selling, General and Administrative Expenses	112,303,000	104,045,000
Depreciation and Amortization	5,787,000	5,173,000
Interest—Mortgages	1,005,000	904,000
Interest—Other	4,040,000	4,612,000
	524,877,000	517,182,000
(Loss)/Earnings from continuing operations before Federal income taxes	(1,683,000)	7,808,000
(Credit)/Provision for Federal Income Taxes (Note J):		
Current	(1,507,000)	3,492,000
Deferred	682,000	125,000
	(825,000)	3,617,000
(Loss)/Earnings from continuing operations	(858,000)	4,191,000
(Loss) from operations discontinued and to be discontinued —net of taxes (Note C)	(6,208,000)	(3,623,000)
(Loss)/Earnings before extraordinary items	(7,066,000)	568,000
Extraordinary Items—(charge)/credit—net of taxes (Note D)	(33,249,000)	895,000
Net (Loss)/Earnings	(40,315,000)	1,463,000
Retained Earnings—at beginning of year	43,201,000	41,738,000
Retained Earnings—at end of year (Note E)	$ 2,886,000	$ 43,201,000
Per share of Common Stock (based on weighted average outstanding shares):		
(Loss)/earnings from continuing operations	($.16)	$.77
(Loss) from operations discontinued and to be discontinued	(1.13)	(.66)
(Loss)/earnings before extraordinary items	(1.29)	.11
Extraordinary items—(charge)/credit—net of taxes	(6.08)	.16
Net (Loss)/Earnings	($7.37)	$.27

*Reclassified.

See accompanying notes to financial statements.

CONSOLIDATED BALANCE SHEETS

Interstate Stores, Inc. and Subsidiary Companies



	1972 (Jan. 28, 1973)	1971 (Jan. 30, 1972)
ASSETS		
Current Assets:		
Cash	$ 12,860,000	$ 15,921,000
Short-term investments—at cost (approximate market $2,115,000 and $500,000, respectively)	1,253,000	500,000
Accounts receivable:		
Customers (net of allowances of $375,000 and $431,000, respectively)	10,271,000	10,891,000
Other (Note G)	10,307,000	9,381,000
Refundable Federal income taxes	7,026,000	656,000
Merchandise inventories (at the lower of cost or market, determined principally by the retail method)	101,012,000	121,190,000
Fixed assets held for sale (Notes C and D)	3,088,000	211,000
Prepaid expenses	3,071,000	3,377,000
Total Current Assets	148,888,000	162,127,000
Other Assets (Note G)	4,407,000	7,591,000
Fixed Assets—at cost (Notes C, D and E):		
Relating to continuing operations:		
Land and buildings	33,914,000	36,559,000
Furniture and equipment	45,668,000	60,544,000
Leaseholds and leasehold improvements	24,998,000	27,542,000
	104,580,000	124,645,000
Less: Accumulated depreciation and amortization	27,633,000	28,388,000
	76,947,000	96,257,000
Relating to operations discontinued and to be discontinued, net of reserves	2,059,000	
Deferred Charges	1,563,000	2,121,000
Intangibles Applicable to Subsidiaries Acquired (in 1972 applicable solely to subsidiaries engaged in the retail toy business) (Note D)	14,651,000	18,127,000
	$248,515,000	$286,223,000

See accompanying notes to financial statements.



LIABILITIES

	1972 (Jan. 28, 1973)	1971 (Jan. 30, 1972)
Current Liabilities:		
Notes payable—banks		$ 17,000,000
Current installments of long-term debt (Note E)	$ 1,148,000	2,088,000
Mortgage applicable to fixed assets held for sale	623,000	
Accounts payable—trade	54,556,000	67,447,000
Accrued expenses and other liabilities	15,225,000	14,973,000
Taxes withheld and accrued, other than Federal income taxes	7,315,000	6,817,000
Accrued Federal income taxes	925,000	1,383,000
Reserve applicable to store closing program—current portion (Note D)	13,900,000	
Total Current Liabilities	93,692,000	109,708,000
Reserve Applicable to Store Closing Program—noncurrent portion (Note D)	1,500,000	
Long-term Debt (Note E)	90,286,000	66,425,000
Deferred Items (including Federal income taxes of $523,000 and $7,563,000, respectively)	4,510,000	11,372,000
Total Liabilities and Deferred Items	189,988,000	187,505,000
Stockholders' Equity (Notes E and I):		
Common Stock (stated at par value of $1 per share, plus $1,271,000 retained as Capital by resolution of the Board of Directors):		
	Shares	
	1972 / 1971	
Authorized	10,000,000 / 10,000,000	
Issued	5,474,709 / 5,473,456	6,746,000 / 6,745,000
Additional Capital		48,919,000 / 48,796,000
Retained Earnings		2,886,000 / 43,201,000
		58,551,000 / 98,742,000
Less: Treasury Stock—at cost—5,800 shares		24,000 / 24,000
		58,527,000 / 98,718,000
Commitments, Contingencies and Other Comments (Notes B, C, D, E, F, G, H, J and K)		
	$248,515,000	$286,223,000

See accompanying notes to financial statements.

CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION

Interstate Stores, Inc. and Subsidiary Companies



	1972 (Year Ended Jan. 28, 1973)	1971* (Year Ended Jan. 30, 1972)
Financial resources provided from:		
Continuing operations:		
(Loss)/earnings from continuing operations	($858,000)	$ 4,191,000
Add—Items not requiring outlay of working capital during the year:		
Depreciation and amortization of fixed assets	5,787,000	5,173,000
Deferred Federal income taxes	682,000	125,000
Amortization of store pre-opening expenses	768,000	1,500,000
Other—net	443,000	14,000
	6,822,000	11,003,000
Operations discontinued and to be discontinued:		
(Loss) from operations discontinued and to be discontinued	(6,208,000)	(3,623,000)
Add/(deduct)—Items not requiring outlay of, or (providing), working capital during the year:		
Depreciation and amortization of fixed assets	1,897,000	2,063,000
Deferred Federal income taxes	(1,283,000)	310,000
Amortization of store pre-opening expenses	150,000	612,000
	(5,444,000)	(638,000)
Funds provided from operations, exclusive of extraordinary items	1,378,000	10,365,000
Increase in long-term debt	27,510,000	1,250,000
Sale of fixed assets (including $3,088,000 and $211,000, respectively, of fixed assets held for sale included in current assets), net of mortgages thereon of $2,239,000 and $3,487,000, respectively	4,223,000	2,851,000
Decrease in other assets	2,583,000	423,000
	35,694,000	14,889,000
Financial resources used for:		
Working capital used for extraordinary items:		
Extraordinary items—charge/(credit)	33,249,000	(895,000)
Add/(deduct)—Items not requiring (outlay) of, or providing, working capital during the year:		
Provision for loss on disposition of fixed assets on stores closed and to be closed	(11,262,000)	
Deferred Federal income taxes	6,439,000	
Write-off of intangibles applicable to discount store divisions	(3,612,000)	
Asset received not providing funds during the year		1,371,000
Other	(2,008,000)	
Working capital used for extraordinary items	22,806,000	476,000
Fixed assets acquired	8,020,000	12,679,000
Store pre-opening expenses	538,000	1,332,000
Repayments and current maturities of long-term debt	1,398,000	3,184,000
Other—net	155,000	71,000
	32,917,000	17,742,000
Increase/(decrease) in working capital	$ 2,777,000	($ 2,853,000)

(Continued)



Increase/(decrease) in working capital, by element:	1972 (Year Ended Jan. 28, 1973)	1971* (Year Ended Jan. 30, 1972)
Cash	($ 3,061,000)	$ 5,965,000
Short-term investments	753,000	(510,000)
Accounts receivable:		
Customers, net	(620,000)	(270,000)
Other	926,000	174,000
Refundable Federal income taxes	6,370,000	
Merchandise inventories	(20,178,000)	(4,892,000)
Fixed assets held for sale	2,877,000	(1,655,000)
Prepaid expenses	(306,000)	296,000
Notes payable—banks	17,000,000	(17,000,000)
Current installments of long-term debt	940,000	(869,000)
Mortgage applicable to fixed assets held for sale	(623,000)	615,000
Accounts payable—trade	12,891,000	16,587,000
Accrued expenses and other liabilities	(252,000)	626,000
Taxes withheld and accrued, other than Federal income taxes	(498,000)	(1,419,000)
Reserve applicable to store closing program	(13,900,000)	
Accrued Federal income taxes	458,000	(501,000)
Increase/(decrease) in working capital	$ 2,777,000	($ 2,853,000)

*Reclassified.
See accompanying notes to financial statements.

NOTES TO FINANCIAL STATEMENTS

General—The consolidated financial statements as at and for the year ended January 30, 1972, as reclassified (see Note C), are presented for comparative purposes. Reference should be made to the Company's Annual Report to Stockholders for that year for the report of the independent public accountants, which contains a qualification of opinion with respect to the tax matter referred to in Note F herein.

Note A—The Company's significant accounting policies are as follows:

1. The consolidated financial statements include the accounts of the Company, all subsidiaries and all majority-owned joint ventures. All significant intercompany items and transactions have been eliminated in consolidation.

2. Depreciation and amortization, for financial reporting purposes, are provided on the straight-line method. Accelerated methods are used for Federal income tax purposes; applicable deferred taxes are provided for the timing differences.

3. Investment tax credits are included in income, as a reduction of the provision for Federal income taxes, when the related property is acquired ("flow-through" method).

4. Pre-opening expenses are amortized over a twelve-month period from the date a store opens.

5. The intangibles applicable to acquired subsidiaries engaged in the retail toy business are not amortized since in the opinion of management there is no indication of loss of utility or of limitation of the useful lives thereof.

Note B—During the year ended January 28, 1973, the Company incurred a substantial consolidated net loss, attributable to its White Front and Topps discount store divisions. Further, during such year and the several months thereafter, the Company experienced difficulties in obtaining its customary merchandise and credit terms required to operate its stores in the normal course of business. The foregoing affected the Company's credit position with its institutional lenders. Management has adopted programs designed to eliminate certain loss operations, improve the results of other loss operations, generate cash and restore the Company's relationships with vendors and lenders.

These programs include (i) the closing of 19 White Front stores in the latter part of the fiscal year ended January 28, 1973, (ii) a decision in April 1973 for the planned closing of 19 Topps stores during the spring and summer of 1973 and (iii) reductions in buying, distribution and administrative expenses. With respect to the 18 remaining White Front stores, which have been and continue to be unprofitable as presently operated, the Company is negotiating to convert 16 stores into substantially leased departments, retaining for its own operation the major appliance and radio and components departments. In connection with the above store closing and leased department programs ("Store Programs"), the Company recorded an extraordinary charge of $33,878,000 (see Note D).

With respect to the remaining 48 Topps stores and two of the White Front stores, substantially all of which have been unprofitable during the year ended January 28, 1973 and the several months thereafter, the Company is instituting programs designed to improve their operating results. In the event the Company's objectives are not satisfactorily achieved, management would have to consider other alternatives, including the possible disposition of certain of these stores, the effects of which are not presently determinable.

Under terms and conditions more fully described in Note E, certain loan agreements with institutional lenders were restructured on June 13, 1973. Among other matters, the restructured agreement (i) had the effect of deferring repayments of $3,250,000 due in August 1973 and $950,000 due in January 1974, (ii) provided for certain new and revised covenants, and (iii) pledged to the lenders, as collateral security for present and future obligations, the capital stocks of all of the Company's subsidiaries. In addition, the Company borrowed $5,000,000 on June 13, 1973, collateralized by a second security interest in the aforementioned capital stocks, and providing for generally similar covenants (see Note E).

Management believes that the Store Programs, the restructuring of the loan agreements with institutional lenders and the additional borrowing of $5,000,000 will enable the Company to restore its relationship with vendors and others so that it will be able to (i) obtain its customary merchandise and credit terms required to operate its stores in the normal course of business, (ii) effect improvement in the operating results of its discount stores, including arrangements for the conversion of the 16 White Front stores into substantially leased departments and the consummation of such arrangements by September 1, 1973, (iii) maintain the profitability of its toy and department store divisions, the earnings of which normally are realized primarily in the fourth fiscal quarter, and (iv) finance the substantial consolidated operating losses which it anticipates for each of the first three quarters of the fiscal year beginning January 29, 1973; a portion of these anticipated operating losses relate to the 19 Topps stores to be closed and the White Front stores

to be converted into substantially leased departments. Management believes further that the foregoing will enable the Company to return to profitable operations in the future and comply with the terms and covenants of the aforementioned loan agreements and borrowing arrangements. The Company's continuation as a going concern, and the appropriateness of presenting the consolidated financial statements as at January 28, 1973 and for the year then ended on a going concern basis, are dependent upon the achievement of substantially all of the foregoing.

Note C—As set forth in Note B, the Company closed 19 White Front stores in 1972 and intends to close 19 Topps stores in 1973; in connection therewith, certain related buying, distribution and administrative expenses have been or are intended to be eliminated. The results of operations of the 38 stores and such related expenses are shown in the accompanying consolidated statements of operations and retained earnings as "Loss from operations discontinued and to be discontinued—net of taxes" and are summarized as follows:

	1972	1971
Net Sales:		
Owned departments	$128,756,000	$144,990,000
Leased departments	33,707,000	39,067,000
	162,463,000	184,057,000
Costs and expenses, net	175,079,000	191,092,000
	(12,616,000)	(7,035,000)
Federal income taxes (credit)	(6,408,000)	(3,412,000)
	($6,208,000)	($3,623,000)

See Note D for extraordinary charge relating to discontinued and to be discontinued operations.

Fixed assets relating to operations discontinued and to be discontinued consist of:

Furniture and equipment	$17,149,000
Leaseholds and leasehold improvements	5,947,000
	23,096,000
Less accumulated depreciation and amortization	7,391,000
	15,705,000
Less reserve for loss on disposal—see Note D	11,262,000
	4,443,000
Less amount included in current assets—see Note D	2,384,000
	$ 2,059,000

Fixed assets relating to continuing operations include land and buildings of four of the stores closed and to be closed in the net book amount of approximately $13,000,000 (subject to mortgages of approximately $12,000,000). It is the Company's intention to sell or lease such store properties.

Note D—The extraordinary credit in 1971 represents a gain on the disposition of an option, net of taxes of $805,000. The extraordinary items in 1972 consist of:

Losses under Store Programs:

Loss incurred in connection with the closing of the 19 White Front stores (exclusive of amounts included below)—principally relating to the liquidation of inventories	$9,713,000 (1)
Write-off of intangibles applicable to discount store divisions	3,612,000
Provision for loss on disposal of fixed assets	11,262,000 (2)
Provision for loss on disposal or subleasing of owned or leased premises (estimated by management to be substantially equivalent, in the aggregate, to one year's net occupancy costs)	8,507,000 (3)
Provision for loss on disposal of inventories (Topps stores to be closed and White Front stores to be converted into substantially leased departments)	5,256,000
Provision for other costs and losses	1,934,000 (4)
	40,284,000
Less tax credit	6,406,000
	33,878,000
Other (credit), net of taxes of $306,000	(629,000)
	$33,249,000

(1) With respect to the closing of certain of the White Front stores, the Company commenced liquidating substantial portions of its inventories during the 1972 Christmas selling season in order to minimize the loss ultimately to be realized through a bulk sale. During such Christmas selling season, management estimates that these stores operated at a loss of approximately $800,000 represented by a net of (i) a loss of $1,800,000 from extraordinary inventory liquidations (included in the extraordinary charge) and (ii) an operating profit of $1,000,000 (included in loss from discontinued operations); management estimates that the latter is comparable to the operating profit for such stores for the same period in 1971.

(2) The provision for loss on disposal of fixed assets has been estimated by management at 100% of the net book amounts of leaseholds and leasehold improvements and 65% of the net book amounts of furniture and fixtures of the stores closed and to be closed. Management has further estimated that $2,384,000 of the resulting proceeds will be received during the fiscal year ending February 3, 1974 and accordingly, such amount has been included in current assets under "Fixed Assets held for sale" (see Note C).

(3) With respect to stores closed and to be closed, the Company is attempting to sublet or dispose of its leased premises and to sell or lease to others its owned properties (see Note C). The provision for loss thereon has been estimated by management to be substantially equivalent, in the aggregate, to one year's net occupancy costs. Based on management's estimate $1,500,000 of such provision has been classified as a noncurrent liability.

Minimum annual rentals with respect to the stores closed and to be closed aggregate $5,800,000 and expire $1,000,000 prior to 1987, $1,900,000 between 1987 and 1992 and $2,900,000 after 1992; certain of the leases provide for additional charges for real estate taxes, insurance, etc.

(4) In connection with the closing of the 19 White Front stores and the planned closing of the 19 Topps stores, the Company was and will be compelled to terminate the licenses of various concessionaires operating in such stores. In some instances the related agreements permit such termination and in other instances no right of termination exists. The termination of such licenses may give rise to liability, particularly in those instances where no right of termination exists, and possibly in those instances where at least a contract right of termination exists. Included in the provision for other costs shown above is approximately $1,200,000, which the Company believes is adequate to settle all claims which may arise with respect to the foregoing. See Note K for actions brought against the Company by certain licensees, of which one action arises from the closing of the stores.

Management believes it has provided amounts sufficient to absorb the future costs and losses under the Store Programs; however, since these are prospective in nature, management is unable to determine at this time the aggregate costs and losses which will ultimately be incurred. The provisions therefor are included in the consolidated balance sheet as at January 28, 1973 as follows:

Reserve for loss on disposal of fixed assets—see Note C	$11,262,000
Reserve applicable to store closing program—current portion	13,900,000
Reserve applicable to store closing program—noncurrent portion	1,500,000
	$26,662,000

The foregoing does not give effect to operating losses subsequent to January 28, 1973 with respect to stores to be closed.

Note E—Long-term debt consists of:

		1972	1971
Domestic bank loan	(1)	$27,000,000	
Eurodollar bank loan	(1)	13,000,000	$13,000,000
Insurance company loan	(1)	5,750,000	6,500,000
4% Convertible Subordinated Debentures due August 1, 1992	(2)	20,000,000	20,000,000
4⅝% Convertible Subordinated Debentures due August 1, 1981	(2)	441,000	453,000
Mortgages	(3)	24,739,000	28,211,000
Other		504,000	349,000
		91,434,000	68,513,000
Less current installments		1,148,000	2,088,000
		$90,286,000	$66,425,000

(1) On December 12, 1972, the Company entered into a domestic bank credit agreement for $51,000,000. Of that amount, $27,000,000 was borrowed by January 28, 1973 and the remainder ($24,000,000) was borrowed subsequent thereto.

On May 14, 1973, the Company was obligated to certain institutions, as follows:

Domestic banks (as above)	$51,000,000
Eurodollar banks	13,000,000
Insurance companies	5,750,000
	$69,750,000

As described hereinafter, the various loan agreements relating to the foregoing obligations were restructured under the terms of an amendatory credit agreement dated as of May 14, 1973, but effective June 13, 1973. In the preparation of the consolidated balance sheet as at January 28, 1973, retroactive effect has been

given to the terms of such agreement which deferred repayment beyond February 3, 1974 of that portion of such debt ($4,200,000) which was due before such date.

Under the amendatory agreement, amounts due the domestic banks and the insurance companies are evidenced by notes due July 31, 1974 which, provided the Company has complied with the terms and covenants of the credit agreement, are renewable by the Company every 90 days thereafter, subject to the provisions for reduced availability referred to below. The amounts due to the Eurodollar banks are evidenced by notes due August 31, 1973. Provided the Company has complied with the terms and covenants of the credit agreement exclusive of those referred to in the second succeeding paragraph hereof, the banks have agreed to renew the notes to July 31, 1974. Thereafter, provided the Company has complied with the terms and covenants of the credit agreement, the Eurodollar notes are renewable for six-month periods, subject to the provisions for reduced availability referred to below.

The aggregate loans available under the amendatory agreement reduce by $13,950,000 on each of December 31, 1974 and December 31, 1975, with the remaining balance of $41,850,000 payable on December 31, 1976. Interest is payable (i) semiannually on the Eurodollar loan at 1½% over first class bank rates for six-month U.S. dollar deposits in the Eurodollar market and (ii) monthly on the remainder at ½% above the current lending rate in effect at one of the banks; as at May 14, 1973 such rates would be 10% and 7½% respectively.

Under the amendatory agreement, if the Company fails to comply with the requirements set forth hereinafter in this paragraph at any time prior to July 31, 1974, the remedies available to the lenders do not become effective until July 31, 1974. Among other matters, the Company has covenanted and agreed to (i) certify to the institutions quarterly that it has complied substantially with its Store Programs (see Note B), (ii) maintain on and after February 3, 1974 (a) consolidated net worth of not less than $45,000,000, and (b) a ratio of consolidated current assets to total consolidated liabilities (exclusive of mortgage and subordinated debt) of not less than 1 to 1—such ratio was approximately 1.05 to 1 at January 28, 1973 (such ratio, as well as the Company's net worth, would decline as a result of losses subsequent to January 28, 1973) and (iii) represent, commencing July 31, 1974, that there has been no material adverse change in the business, property or assets of, or in the condition (financial or otherwise) of, the Company and any of its consolidated subsidiaries on a consolidated basis from that set forth in the Company's consolidated balance sheet as at January 28, 1973, provided, however, that a net loss before extraordinary items during any fiscal period shall not be deemed to be a "material adverse change" so long as the Company and its subsidiaries shall be in due compliance with all of the other provisions of the credit agreements and the other instruments and agreements referred to therein.

Aside from the foregoing, there are other requirements under the agreements with which the Company must comply on a current basis. Among these are punctual payment of interest, timely submission of specified financial information, and prompt advice to the lenders upon the happening of certain events. In addition, there are restrictions, among others, upon the creation of indebtedness or liens, the making of investments, the disposal of assets, capital expenditures, and guarantees by and mergers and consolidations with subsidiaries.

Under the terms of the domestic bank credit agreement, the Company may not pay any dividends (other than stock dividends).

As a condition of the amendatory agreement, the Company pledged (i) the capital stocks of all of its subsidiaries, and (ii) certain other stock (included in the consolidated balance sheet at $113,000), as collateral security for all present and future obligations to the lenders (other than to their factoring divisions). Substantially all of the consolidated net assets and operations are attributable to such subsidiaries. Included therein are the operations of the Company's toy and department store divisions. Such divisions, for the year ended January 28, 1973, had earnings of approximately $18,900,000 before Federal income taxes and allocation of interest and home office expenses.

Under separate instruments dated as of April 23, 1973, all of the Company's subsidiaries have executed guarantees of the Company's present and future obligations to the lenders under the credit agreements.

(2) The indentures applicable to the 4⅝% and 4% Debentures require annual redemptions of $275,000 and $900,000, respectively, aggregating $275,000 through 1977, $1,175,000 from 1978 to 1980, and $900,000 from 1981 to 1991. Each Debenture's annual redemption requirement is subject to reduction, at the

Company's option, for prior conversions, which aggregate $5,419,000 (applicable solely to the 4⅝% Debentures) as at January 28, 1973. It is the Company's present intention to exercise this option. The 4⅝% and 4% Debentures are subordinated to indebtedness for money borrowed, and may be converted into Common Stock at conversion prices of $9.40 and $43.89 a share, respectively. During the years ended January 28, 1973 and January 30, 1972, $12,000 and $32,000 of the 4⅝% Debentures were converted into 1,253 and 3,453 shares of Common Stock, resulting in increases in Common Stock of $1,000 and $4,000 and in Additional Capital of $11,000 and $28,000. Based upon the foregoing conversion prices, the outstanding Debentures as at January 28, 1973 are convertible into 502,568 shares of Common Stock.

(3) The mortgages (i) bear interest at annual rates of 4½% to 9⅞%, (ii) are payable in varying installments with final payments becoming due in 1975-2002 and (iii) are collateralized by fixed assets having a depreciated cost of approximately $29,000,000. See Note G as to long-term debt (not included herein) of 50% owned corporations and joint ventures.

(4) On June 13, 1973, the Company borrowed $5,000,000 (including $300,000 from the Company's Chairman of the Board and $500,000 from a company in which one of the coventurers referred to in Note G is a stockholder) and issued Senior Subordinated Notes payable on January 1, 1977. Interest on the Notes is payable monthly at 2% over prime rate, as defined. The Notes are subordinated to all present and future obligations to the lenders referred to in (1) above (other than to their factoring divisions). Further, the agreement relating to the Notes (i) provides that the Notes are to be collateralized by a second security interest in the capital stocks of all of the Company's subsidiaries, and certain other stock, pledged to the lenders referred to in (1) above, and (ii) requires the Company, among other matters to comply with covenants generally similar to those contained in the amended credit agreements with such lenders. The agreement relating to the Notes also provides for the issuance of warrants (exercisable commencing November 30, 1973 and expiring November 30, 1978) for the purchase of 1,000,000 shares of the Company's Common Stock at an exercise price of $3.00 a share; the exercise price may be satisfied by cash, the surrender of notes or any combination thereof.

Note F—The Internal Revenue Service has proposed deficiencies in income taxes against the Company and its subsidiaries for the seven years ended January 31, 1968. The proposed assessments, if sustained in their entirety, would result in additional taxes of approximately $3,800,000 (net of an $800,000 duplication in the proposed assessment applicable to certain subsidiaries) exclusive of interest. The major portion of the proposed assessment involves constructive dividends purportedly received by the Company from its subsidiaries. Should the Internal Revenue Service attempt to apply the same theory to the year ended February 2, 1969, the Company could be subject to an additional deficiency of $950,000. Commencing with the year ended January 31, 1970, the companies filed consolidated tax returns and the issue as to constructive dividends would no longer be applicable.

The Company considers the proposed assessments improper; the Company has already filed formal protests with respect thereto and firmly believes that the ultimate disposition of this tax matter would have no material adverse effect upon the accompanying financial statements. Accordingly, no provisions for Federal income taxes or related interest have been made for the foregoing.

Note G—Subsidiaries of the Company have 50% interests in a number of corporations and joint ventures, whose functions are to acquire properties, construct store buildings thereon and lease all or substantial portions thereof to other subsidiaries. The investments in (carried at proportionate share of underlying equity) and advances to these companies aggregated $2,563,000 and $2,900,000 as at January 28, 1973 and January 30, 1972, respectively. Of these amounts $341,000 (1972) and $87,000 (1971) are included in Accounts Receivable—Other and $2,222,000 (1972) and $2,813,000 (1971) are included in Other Assets. The subsidiaries' share of net income/(loss) of these entities included in Other Income—Net aggregated ($96,000)—1972 and $197,000—1971.

As at their respective fiscal year-end dates (December 31 or January 31) net fixed assets and long-term debt of the above 50% owned entities, not included in the Consolidated Balance Sheets, were as follows:

	1972	1971
Net fixed assets	$61,360,000	$63,416,000
Long-term debt	$58,252,000	$57,114,000

As at January 28, 1973, subsidiaries of the Company were contingently liable as to $2,000,000 of the above long-term debt. The obligations bear interest at an-

nual rates of 5¼ % to 10¼ % and are payable in varying installments with final payments becoming due in 1985-2002.

The consolidated statements of operations and retained earnings include amounts received from and paid to some of the 50% owned companies and joint ventures, as follows: income representing fixed annual amounts and/or amounts equivalent to cash flow from real estate (as defined in certain joint venture agreements) of $1,190,000 (1972) and $530,000 (1971); interest income of $9,000 (1972) and $8,000 (1971); and rentals paid of $6,667,000 (1972) and $6,307,000 (1971).

Note H—Minimum annual rentals of real property leased to the Company or to its subsidiaries (including rentals applicable to stores closed and to be closed —see Note D) amount to approximately $22,200,000 (of which $6,667,000 is under leases with 50% owned corporations and joint ventures referred to in Note G) plus, in certain instances, additional rentals based upon sales and charges for real estate taxes, insurance, etc. Of the aggregate annual rentals, $7,300,000 expires prior to 1987, $5,100,000 expires between 1987 and 1992, and $9,800,000 expires after 1992.

At January 28, 1973, the Company and certain subsidiaries were contingently liable for approximately $2,700,000 relating to certain of their landlords' obligations; such contingent liabilities are subject to reduction to the extent that required payments are made by the landlords against such obligations.

Note I—Under the Company's stock option plans, options to purchase 22,375 shares may be granted to December 1973 and for 61,200 shares to 1978, at not less than the fair market values at dates of grant. Depending on the plan, options are either exercisable 25% a year (on a cumulative basis) commencing one year from date of grant or are exercisable in full after four years and nine months from date of grant. Options expire five years from date of grant. Changes in shares subject to outstanding stock options under the plans are as follows:

	1972	1971
Outstanding at beginning of year	185,900	168,048
Granted	75,650	74,300
Lapsed	(40,074)	(29,533)
Cancelled		(22,500)
Exercised		(4,415)
Outstanding at end of year ($6.94 to $45.38 a share—1972)	221,476	185,900
Exercisable at end of year	32,376	22,099

During the year ended January 28, 1973, the Company granted to an officer a nonqualified option to purchase 25,000 shares of the Company's Common Stock at $2.00 a share (market value at date of grant $6.50 a share). The option is exercisable 33⅓ % a year (on a cumulative basis) commencing one year from date of grant and expires five years from date of grant. The excess ($112,000) of the market value of the shares over the option price has been recorded as a deferred charge (being amortized over the term of the related employment agreement) and credited to Additional Capital.

Note J—Based upon tax returns filed and to be filed by the Company for fiscal years ended through January 28, 1973, the companies have available net operating loss carryforwards aggregating $13,900,000, of which $1,400,000 may be utilized only to offset taxable income of certain subsidiary corporations and expires in 1974 and $12,500,000 may be utilized to offset consolidated taxable income in future years through 1978. The companies will be entitled to additional deductions to the extent that and at such time as certain costs and losses provided for in the accompanying consolidated financial statements (see Note D) become deductible for tax purposes. Further, the companies have available investment tax credit carryforwards aggregating $1,400,000 which may be utilized under certain circumstances and expire in various years through 1980.

Investment tax credits amounted to $240,000 (including $45,000 carried forward from prior years) for the year ended January 30, 1972.

Note K—The licensee which operated one of the leased departments in several of the closed White Front stores (see Note D) has instituted (i) a cross-complaint against the Company and others based upon an alleged breach of contract and other grounds (a) claiming compensatory damages in an unspecified amount but referring to losses in excess of $1,060,000, and (b) seeking punitive damages in the amount of $5,000,000, and (ii) an action against the Company predicated on the Sherman Antitrust Act seeking damages in an unspecified amount but referring to loss of profits in excess of $2,000,000 and asking that this sum be trebled. Further, in response to an action by the Company seeking to recover amounts due from another licensee which vacated certain White Front stores before their closing, the licensee cross-complained against the Company seeking alleged actual

damages of $2,700,000 and punitive damages of $1,000,000, based upon breach of covenant and joint venture theories.

In the opinion of the Company and its counsel, the claims in the foregoing litigation are grossly exaggerated. Further, it is the opinion of the Company and its counsel with respect to the foregoing and other actions, suits or proceedings pending or, to the best of their knowledge, threatened against or affecting the Company or any subsidiary, that their ultimate disposition could result in no material adverse change in the operations or financial condition of the Company and its subsidiaries on a consolidated basis.

ACCOUNTANTS' REPORT

To the Board of Directors

Interstate Stores, Inc.

New York, N.Y.

We have examined the consolidated balance sheet of Interstate Stores, Inc. and subsidiary companies as at January 28, 1973, and the related consolidated statements of operations and retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As set forth in Note D, the Company has provided reserves aggregating $26,662,000 for costs and losses to be incurred in connection with its store closing programs. No determination can be made at this time as to the amount of costs and losses which will ultimately be sustained in connection with the foregoing nor as to the current and noncurrent classifications of such reserves and of the related fixed assets in the consolidated balance sheet as at January 28, 1973.

As set forth in the consolidated statement of operations and retained earnings, the Company incurred a substantial consolidated net loss for the year ended January 28, 1973. Further, as set forth in Note B, during such year and the several months thereafter, the Company experienced difficulties in obtaining its customary merchandise and credit terms required to operate its stores in the normal course of business. The foregoing affected the Company's credit position with its institutional lenders. During the year ended January 28, 1973 and thereafter, management (i) adopted programs designed to eliminate certain loss operations, to improve the results of other loss operations and to generate cash (see Note B), (ii) arranged for the restructuring of its loan agreements with institutional lenders, under which, among other matters, certain repayments were deferred, new and revised covenants were provided, and the capital stocks of all the Company's subsidiaries were pledged to the lenders as collateral security (see Note E), and (iii) arranged for the borrowing of $5,000,000, collateralized by a second security interest in such capital stocks, and providing for generally similar covenants (see Note E). Management believes that these programs, agreements and borrowings will enable the Company to restore its relationships with vendors and others so that it will be able to (i) obtain its customary merchandise and credit terms required to operate its stores in the normal course of business, (ii) effect improvement in the operating results of its discount stores, including arrangements for the planned conversion of sixteen White Front stores into substantially leased departments, (iii) maintain the profitability of its toy and department store divisions, and (iv) finance the substantial consolidated operating losses which it anticipates for each of the first three quarters of the fiscal year beginning January 29, 1973. Management believes further that the foregoing will enable the Company to return to profitable operations in the future and to comply with the terms and covenants of the aforementioned loan agreements and borrowing arrangements. The Company's continuation as a going concern and the appropriateness of presenting the consolidated financial statements as at January 28, 1973 and for the year then ended on a going concern basis (which contemplates the realization of assets and the liquidation of liabilities in the normal course of business) are dependent upon the accomplishment of substantially all of the foregoing. We are in no position to evaluate the achievability of these programs and objectives, which are dependent upon a number of future events, including the acceptance by vendors and others of the newly restructured loan agreements and borrowing arrangements effected on June 13, 1973.

In our opinion, subject to (i) the achievement of the programs and objectives referred to in the preceding paragraph so as to enable the Company to continue as a going concern, and (ii) the effects of the matters referred to in the second paragraph hereof and of the tax matter referred to in Note F, the above-mentioned financial statements present fairly the consolidated financial position of Interstate Stores, Inc. and subsidiary companies at January 28, 1973 and the consolidated results of their operations and consolidated changes in their financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

S. D. LEIDESDORF & CO.

New York, N.Y.
May 1, 1973, except for Notes B and E,
which are as of June 13, 1973

FIVE YEAR FINANCIAL HIGHLIGHTS
(000's omitted)

Interstate Stores, Inc. and Subsidiary Companies

Operations	1972	1971	1970	1969	1968
Continuing Operations:					
Sales of owned departments	$452,617	$451,006	$428,876	$410,494	$368,826
Leased department sales	68,765	73,370	77,473	78,343	76,797
Total	$521,382	$524,376	$506,349	$488,837	$445,623
Earnings (losses) before taxes	$ (1,683)	$ 7,808	$ 7,834	$ 17,695	$ 20,956
Provision (credit) for income taxes	(825)	3,617	3,869	8,763	10,396
Earnings (losses) from continuing operations	(858)	4,191	3,965	8,932	10,560
Earnings (losses) from non-continuing operations	(6,208)	(3,623)	(2,592)	(132)	421
Earnings (losses) before extraordinary items	(7,066)	568	1,373	8,800	10,981
Extraordinary items, net	(33,249)	895	—	—	—
Net earnings (losses)	$(40,315)	$ 1,463	$ 1,373	$ 8,800	$ 10,981
Financial					
Current assets	$148,888	$162,127	$163,019	$158,222	$127,854
Current liabilities	93,692	109,708	107,747	107,549	72,564
Working capital	55,196	52,419	55,272	50,673	55,290
Current ratio	1.6 to 1	1.5 to 1	1.5 to 1	1.5 to 1	1.8 to 1
Mortgages	23,960	26,828	30,771	21,159	12,155
Other long-term debt	66,326	39,597	41,107	28,813	29,991
Stockholders equity	58,527	98,718	97,171	98,301	76,031
Dividends	—	—	2,456	3,101	2,917
Stores					
Toy stores	45	37	28	21	8
Department stores	28	31	30	31	31
Discount stores	91	107	109	97	86